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## **South Korea-U.S. Economic Relations: Cooperation, Friction, and Future Prospects**

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# South Korea-U.S. Economic Relations: Cooperation, Friction, and Future Prospects

## Summary

South Korea is a major economic partner for the United States. Korea is the U.S.'s seventh-largest trading partner — ahead of Western European countries such as France and Italy — and its sixth-largest export market. Korea has also become a significant investment site for American companies, which have poured nearly \$20 billion into the country over the past seven years. In 2003, the U.S. was Korea's largest trading partner, and its second-largest export market, source of imports, and supplier of foreign direct investment (FDI).

Increased economic interaction has been accompanied by numerous disagreements over trade policies. The intensity of the disputes has diminished considerably since the late 1980s and early 1990s, in part because South Korea has enacted a set of sweeping market-oriented reforms as a *quid pro quo* for receiving a \$58 billion package from the International Monetary Fund (IMF) following the near collapse of the South Korean economy in 1997. In recent years, the United States and South Korea appear to have become more adept at managing their trade disputes, so that they tend to be less acrimonious than they were in the 1980s and 1990s. This is due in part to the quarterly, working-level bilateral trade meetings that were first held in early 2001.

This report summarizes the main issues in U.S.-South Korean economic relations, including South Korea's economic prospects and economic reforms, and major bilateral economic disputes. The report will be updated periodically.

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# South Korea-U.S. Economic Relations: Cooperation, Friction, and Future Prospects

The United States and South Korea (known formally as the Republic of Korea, or ROK) have been allies since the United States intervened in 1950 and fought the Korean War to prevent a North Korean invasion from taking over South Korea. Over 33,000 U.S. troops were killed and over 100,000 were wounded during the three-year conflict. In 1954, a year after the parties to the conflict signed an armistice agreement, the United States and South Korea signed a Mutual Defense Treaty, which provides that if either party is attacked by a third country, the other party will act to meet the common danger. The United States maintains about 37,000 troops in the ROK to supplement the 650,000-strong South Korean armed forces.

Beginning in the 1960s, rapid economic growth in South Korea propelled it into the ranks of the world's largest industrialized countries. For over a decade, South Korea has been one of the United States' largest trading partners. Economic growth also has helped transform the ROK into a mid-level regional power that can influence U.S. policy in Northeast Asia, particularly the United States' approaches toward North Korea and China.

## Overview of U.S.-South Korean Economic Relations

In 2003, trade between the South Korea and the United States was nearly \$60 billion, making South Korea the United States' seventh-largest trading partner — ahead of France and Italy — and its seventh-largest export market. (See Table 2.) For some western states and U.S. sectors, the South Korean market is even more important, ranking number five for California's exporters, number two for Oregon's exporters, and number four for all U.S. agricultural exporters. Major U.S. exports to South Korea include semiconductors, machinery (particularly semiconductor production machinery), aircraft, agricultural products, and beef. South Korea is among United States' largest markets for agricultural products and beef.

### South Korea at a Glance

- |  |   |
|--|---|
| • <b>Head of State:</b> President Roh Moo-hyun | • <b>Arable Land:</b> 19%   |
| • <b>Population:</b> 48.3 million              | • <b>Nominal GDP:</b> \$605 billion (2003); world's 12 <sup>th</sup> -largest economy |
| • <b>Life Expectancy:</b> 75 years             | • <b>Nominal GDP Per Capita:</b> \$12,585 (2003)                                      |
| • <b>Literacy Rate:</b> 98%                    | • <b>Exports:</b> \$194 billion (2003)  |
| • <b>Ethnicity:</b> 100% Korean                | • <b>Imports:</b> \$179 billion (2003)  |
| • <b>Size:</b> slightly larger than Indiana    |   |

**Source:** *The World Factbook 2002*; DRI-WEFA; ROK Ministry of Commerce, Industry, and Energy

South Korea is far more dependent economically on the United States than the United States is on South Korea. In 2003, the United States was Korea's number one trading partner, and its second-largest export market, source of imports, and supplier of foreign direct investment. In 2003, China for the first time displaced the United States from its perennial place as South Korea's number one export market.

**Table 1. Economic Interdependence (2003)**

	Total Trade	Export Market	Source of Imports	Source of FDI
for U.S., ROK ranks	#7	#7	#7	n.a.
for ROK, U.S. ranks	#1	#2	#2	#2
In 2003, China surpassed the U.S. as the ROK's largest export market. For the first four months of 2004, China surpassed the U.S. as the ROK's largest trading partner.				

Increased economic interaction has been accompanied by numerous disagreements over trade policies. The intensity of the disputes has diminished considerably since the late 1980s and early 1990s, in part because South Korea has enacted a set of sweeping market-oriented reforms as a *quid pro quo* for receiving a \$58 billion package from the International Monetary Fund (IMF) following the near collapse of the South Korean economy in 1997. In particular, as a result of the reforms, South Korea has opened its doors to foreign investors, ushering in billions of dollars of foreign portfolio and foreign direct investment (FDI). The result is that foreign companies, including U.S. firms, now are significant shareholders in many prominent industrial conglomerates (*chaebol*), own an estimated 40% of the value of the shares traded on South Korea's stock exchange, and own about one-third of the Korean banking industry. South Korean President Roh Moo-hyun, elected to one five-year term in 2002, has said that more extensive reforms are needed to help accomplish his goals of raising per capita gross domestic product (GDP) to \$20,000 and of transforming South Korea into an major economic hub in Northeast Asia.

The United States and South Korea appear to have become more adept at managing their trade disputes, so that they tend to be less acrimonious than they were in the 1980s and 1990s. This may be partly due to the quarterly, working-level "trade action agenda" trade meetings that were first initiated in early 2001. Both sides credit the meetings, which appear to be unique to the U.S.-South Korean trade relationship, with creating a more constructive dialogue by serving as "action-forcing" events. The most recent meeting occurred in early June 2004.

**Table 2. Annual U.S.-South Korea Merchandise Trade**  
(Billions of U.S. Dollars)

Year	U.S. Exports	U.S. Imports	Trade Balance	Total Trade
1990	14.40	18.49	-4.09	32.89
1995	25.38	24.18	1.20	49.56
1999	22.04	31.15	-9.11	53.19
2000	26.30	39.83	-13.53	66.13
2001	20.89	34.92	-14.03	55.81
2002	21.15	35.28	-14.13	56.43
2003	22.52	36.93	-14.41	59.45
Jan-Apr 2003	7.43	11.36	-3.93	18.79
Jan-Apr 2004	7.91	13.71	-5.80	21.62

**Sources:** 1990-1998 data from Global Trade Information Services. 1999-2003 data from U.S. International Trade Commission.

## South Korea's Economy

### The 1997 Crisis and IMF-Directed Reforms

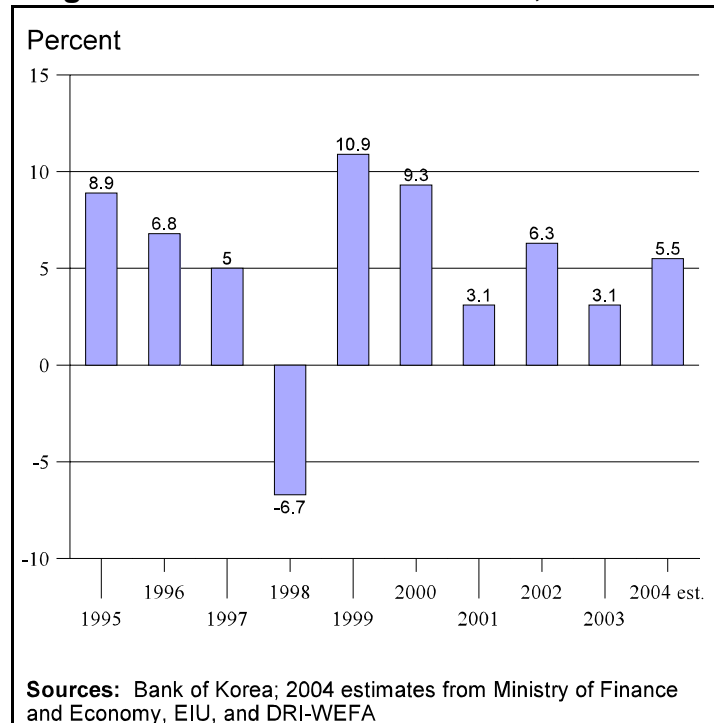
South Korea's 1997 financial crisis was a seminal event in the country's history. During the autumn of 1997 — spurred in part by the bankruptcy of some major industrial conglomerates (*chaebol*) and a sharp increase in repayments required on short-term foreign debt — investors lost confidence in the economy and capital fled the country. The Korean *won* lost half its value in the space of a few days, tumbling from 900 to 1900 won to the dollar. In a futile attempt to prop up the currency, the government's foreign currency reserves dropped to \$4 billion, an amount insufficient to carry the country through another day. Following the collapse of Hanbo Steel in January 1997, six of the country's top 30 *chaebol* went bankrupt. In December 1997, barely a year after joining the Organization for Economic Cooperation and Development (OECD), Seoul turned to the IMF for economic assistance. At virtually the same time, South Koreans elected longtime democracy activist Kim Dae Jung to the presidency, the first time since the early 1960s that an opposition leader had won the country's highest office.

After negotiating for weeks over the details, on December 4, 1997, South Korea and the IMF agreed to a \$58 billion support package. In return, Seoul agreed to tighten its fiscal and monetary policies and engage in far-reaching, market-oriented reforms of its financial and corporate sectors, and of its labor market policies. South Korea also agreed to open its economy further to foreign goods and investors. The newly-elected Kim government adopted most of the structural reforms as its own.

Following the financial crisis, South Korea entered into a severe recession. Gross domestic product (GDP) contracted by 6.7% and unemployment nearly quadrupled, rising to 7.6% in 1998. The slowdown generated substantial anti-IMF and anti-American sentiment among many South Koreans. The economy rebounded

in 1999 and 2000, growing by over 10% and 9%, respectively, and enabling the South Korean government to rapidly retire many of the debts it incurred in 1997.<sup>1</sup> In 2001, however, growth slowed considerably, dragged down by a combination of internal and external developments, including a decline in consumer and business confidence, due in part to a perception that the post-crisis restructuring drive was faltering; the bursting of Korea's stock market bubble; rising oil prices; and a sharp falloff in exports to the United States and Japan, which entered economic downturns of their own. The government responded by lowering interest rates, unveiling an economic stimulus package, and easing the rules on the use of credit cards.

**Figure 1. ROK Real GDP Growth, 1995-2004**



These measures boosted consumer spending, which helped to double the growth rate from 3.1% in 2001 to 6.3% in 2002. Growth also was boosted by rapid economic integration with China. Domestic investment, however, remained low.

## Recent Economic Developments

In 2003, overuse of personal credit cards led to the near-collapse of many financial firms and a sharp slowdown in economic growth, which fell back to 3.1%. Until the late 1990s, the consumer sector of the economy had been largely untapped, with Korean lenders focusing on the corporate sector. Thus, when the government liberalized financial regulations and forced Korea's giant conglomerates to curtail their borrowing in the aftermath of the 1997 crisis, banks and other financial institutions turned to consumers — at times recklessly — as a new source of profit.

<sup>1</sup> In August 2001, Seoul paid off the last of the \$19.5 billion it had borrowed from the IMF.



The number of credit card holders behind in their payments has increased sharply, with an estimated 8% of the population in default as of March 2004.<sup>2</sup> In 2003 and 2004, all eight of Korea's specialized credit-card issuers registered massive losses that collectively were more than double their assets. In most cases, insolvency was avoided only through bailouts and takeovers by affiliated members of the companies' respective *chaebol* groupings. Most of these moves appear to have been engineered, regulatorily enabled, and/or encouraged by the government, which feared a collapse of the financial system if the firms were allowed to fail. The government has responded to the household debt crisis by tightening restrictions on credit card use and issuance, and by initiating a refinancing and forgiveness program for individual debtors.

For 2004, South Korea's finance minister has said that he expects South Korea's economy to rise by close to 6%, as a powerful surge in exports offsets lackluster domestic demand.<sup>3</sup> Private economic forecasters tend to echo this prediction, though the sharp rise in oil prices may curtail growth, as South Korea imports all of its oil.

## Economic Reforms

**Financial Sector and *Chaebol* Reforms.** Assessing Korea's economic reforms to date depends on one's perspective. If the point of comparison is the Korean economy in 1997, then the government's progress has been impressive. South Korea's economy today is far more transparent, open to foreign investors, and efficient than it was seven years ago. Progress has been particularly notable in opening the country to foreign direct investment (see below) and in reforming the financial sector. In the years following the crisis, the government spent about \$140 billion to bail out ailing banks and mutual funds.<sup>4</sup> This amount is approximately 25%-30% of the country's GDP, nearly twice the level required to save Mexico's financial system during its crisis in 1995. Notably, predictions that the government would have to spend substantially more funds have not come to pass, and Korea's banking sector as a whole has returned to profitability. By the end of 2001, non-performing loans (loans which are unlikely to be repaid) had fallen to 2.4% of total loans, compared with 16.4% in 1998. Since 2001, the Korean banking sector as a whole has been profitable. At the end of 2003, the percentage of troubled loans had risen to 2.6%, primarily as a result of the collapse of the credit card bubble.<sup>5</sup> (In 2001, the percentage of non-performing loans for large banks in the United States was 1.5%.) Critics point out that the official South Korean percentage underestimates the problem because many South Korean loans that are unlikely to be repaid have not yet been classified as "non-performing."

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<sup>2</sup> Hye-Seung Seo, "South Korea Unveils Program To Help Ease Consumer Debt," *The Asian Wall Street Journal*, March 11, 2004.

<sup>3</sup> Gordon Fairclough, "South Korea Forecasts Growth Of Near 6% on Export Strength," *The Asian Wall Street Journal*, April 26, 2004.

<sup>4</sup> Francesco Guerrera, et. al., "Seoul Plans to Sell Most of Stake in Hana Bank," *Financial Times*, January 28, 2004.

<sup>5</sup> Economist Intelligence Unit, *South Korea Country Report*, May 2004, p. 32.

The Roh government has accelerated South Korea's efforts to re-privatize the banks that were nationalized in the aftermath of the 1997 crisis. By 2000, the nationalization program had brought about one-third of the banking industry's assets into government hands, and state ownership of the banking sector formed the crux of a major trade dispute with the United States and European Union, in which state-owned and state-controlled banks were accused of illegally subsidizing Hynix Semiconductor Inc., the world's third-largest producer of dynamic random access memory (DRAM) semiconductor chips. By the spring of 2004, however, sales of many of formerly state-owned banks had given foreign companies collectively a major stake in South Korea's financial sector, notwithstanding occasional statements by Korean politicians expressing misgivings about excessive non-Korean ownership. Currently, foreigners own about one-third of the assets in the Korean banking sector, including majority stakes in four of Korea's eight nation-wide banks.<sup>6</sup> In March 2004, Korea's Financial Supervisory Commission approved a \$1.7 billion bid from Citigroup for a controlling stake in KorAm, Korea's seventh-largest bank. Citigroup plans to operate in South Korea under its own name.

If the yardstick used to assess South Korea's reforms is the U.S. economy, however, it becomes clear that Seoul has far to go if it is to make the economy truly responsive to market-oriented pressures and incentives. Progress has been particularly difficult in the government's attempts to pressure the *chaebol* to correct the problems revealed by the 1997 crisis, including excessively high debt levels, a heavy reliance on short-term debt, the lack of transparency, weak corporate governance, and corporate structures dominated by individual families rather than professional business managers. Although two of the largest *chaebol* — Daewoo and Hyundai — have been dismantled and debt-equity ratios for most of the top conglomerates have been reduced, corporate governance and cross-shareholdings within *chaebol* groupings remain major problems. The bailouts of struggling credit card affiliates in 2003 and 2004 seemed to many to indicate that the *chaebol* had not reformed their past practices of forcing their profitable enterprises to rescue failing ones. Also in 2003, a massive accounting scandal at SK Global, the trading unit of the country's fourth-largest *chaebol*, SK Group, revealed similar structural problems.<sup>7</sup>

Additionally, the reckless credit card lending activities of Korean credit card firms exposed the continued weaknesses in risk management and due diligence by Korean financial interests. One of the government's responses has been to accelerate plans to further restructure the financial industry by passing new laws allowing the consolidation of banking, insurance, asset management, and brokerage services. Some critics, however, worry that this cross-sectoral consolidation will accentuate

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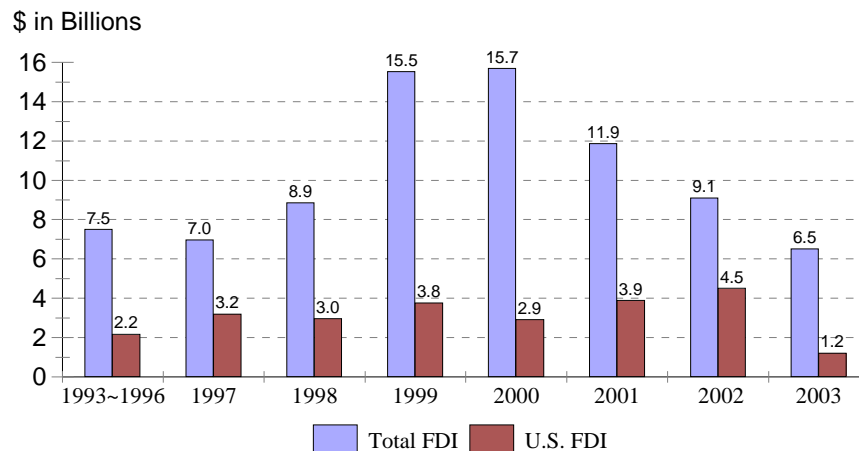
<sup>6</sup> Foreigners also are significant shareholders in many prominent *chaebol* and own an estimated 40% of the value of the shares traded on South Korea's stock exchange.

<sup>7</sup> SK Global (now SK Networks) was found to have window-dressed its financial statements by over 7 trillion *won* (around \$5.8 billion), for which several senior level executives, including SK Corp's chairman were convicted of breaching fiduciary responsibilities. The chairman served a three-month prison term. Following SK Global's restatement of its earnings, SK Corp led a rescue of its subsidiary despite the objections of most of SK Corp's foreign shareholders.

the problem of cross-shareholding within *chaebol* groupings. Additionally, the recent bailouts of the two largest credit card companies, LG Card and Samsung Card, have raised fears that the “too big to fail” dynamic continues to persist in South Korea.

**Foreign Direct Investment Reforms.** As part of its commitment to the IMF in December 1997, Seoul pledged to eliminate most restrictions on foreign firms’ long-term investments in local subsidiaries and controlling interests in local companies. The government of President Kim Dae Jung, who was elected during the nadir of Korea’s financial crisis, moved aggressively to liberalize Korea’s foreign investment regime. Partly as a response to Kim’s reforms, and partly in response to the lower prices of Korean assets following the 1997 crisis, FDI flows increased markedly, soaring from \$3.2 billion in 1996 to a peak of \$15.7 billion in 2000. Since then, FDI has declined significantly, falling to \$6.5 billion in 2003. In 2004, President Roh Moo-hyun’s government began a policy of boosting FDI as a source of domestic growth.<sup>8</sup> Since the 1997 crisis, FDI commitments by U.S. companies have totaled nearly \$20 billion. (See Figure 2.) A number of high-profile Korean companies have been taken over by foreign interests, notably General Motors’ purchase of Daewoo Motors in 2002. Citigroup’s \$1.7 billion purchase of KorAm in March 2004 was the largest foreign direct investment in Korean history.

**Figure 2. Foreign Direct Investment Flows into the ROK, 1993-2003**



Source: ROK Ministry of Commerce, Industry, and Energy

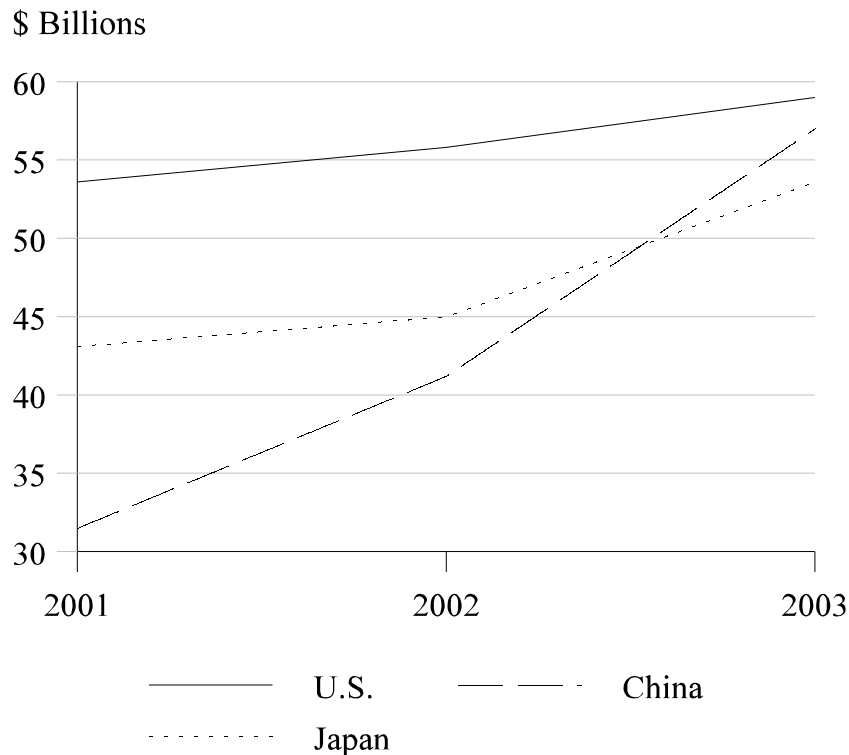
Despite the increased openness to foreign ownership, a number of high-profile acquisitions by foreign companies have been either delayed or cancelled, due to nationalistic objections to the sale, disagreements over the sales price, and/or the discovery of previously undisclosed debts owed by the target Korean company. These delaying actions often have backfired, resulting in far lower eventual sale

<sup>8</sup> In a March 4, 2004 speech to the American Chamber of Commerce of Korea, Minister of Finance and Economy Lee Hun-jai announced the new policy, saying, “foreign direct investment is important not just for short-term recovery of the Korean economy, but also for supporting longer-term growth potential.” Andrew Ward, “Korea Moves to Win Back Foreign Business,” *Financial Times*, March 5, 2004.

prices. A case in point was the protracted sale of Daewoo Motors. In June 2000, Daewoo Motor's creditors, many of them government-owned or controlled, reached a tentative agreement with Ford, which bid nearly \$7 billion for the company. Negotiations became difficult, and after discovering billions of dollars in previously hidden liabilities (and taking a large loss from the Firestone tire recall), Ford withdrew its offer. General Motors, which initially had bid \$4 billion, remained the only viable suitor. Negotiations with creditors and the government dragged on for over a year and a half, however. Finally, in May 2002, GM and Daewoo's creditors signed an agreement, by which GM acquired a controlling stake in Daewoo Motors for \$400 million.

## South Korea's Increased Economic Integration with China

**Figure 3. ROK Trade with U.S., China, & Japan, 2001-2003**



**Source:** KITA

South Korea currently is experiencing a “China boom.” As mentioned earlier, in 2003 China surpassed the United States as South Korea's number one export market. Many, if not most, of South Korean exports to China are intermediate goods used in the production of finished goods that ultimately are exported from China to other countries, including the United States. A growing number of Koreans are studying the Chinese language and traveling to China, and public opinion polls show that a growing number of Koreans have favorable views of China. These developments, combined with a sharp decline in favorable views of the United States, have led many American observers to worry that Chinese influence over South Korean policy is likely to rise in the future, at the expense of the United States.

Many South Koreans, however, have ambivalent views of China's growing economic importance. The increased competitiveness of many Chinese manufacturers has caused some consternation in some South Korean firms, pushing them to search overseas for lower-cost production bases. There are concerns that jobs, particularly in the manufacturing sector, will be lost to Chinese workers as South Korean foreign direct investment in China increases.

## **Improved Inter-Korean Economic Relations**

The worsened economic situation for many South Korean small and medium sized enterprises (SMEs) is thought to be a major factor propelling President Roh Moo-hyun's economic initiatives with North Korea. In particular, the inter-Korean industrial zone in Kaesong, North Korea, just north of the demilitarized zone separating the two countries, is explicitly designed for use by SMEs, over 1,000 of which reportedly have expressed interest in participating. A pilot site at Kaesong, housing the factories of up to ten South Korean firms, is due to open in 2004.

In the past two years, South Korea has emerged as North Korea's second-most important economic partner, after China. Inter-Korean trade has risen by about 80% since 2001, to about \$724 million in 2003. Since 1994, South Korea has given nearly \$3 billion worth of economic and humanitarian aid to North Korea, perhaps surpassing China as Pyongyang's top source of food aid in 2003. Some analysts worry that improved inter-Korean economic relations are undermining the Bush Administration's policy of constricting the inflows of foreign currency that are thought to go to the North Korean elite, providing a critical base of support for North Korean leader Kim Jong-il. Alternatively, coordinated U.S. and South Korean policies could use economic leverage to pressure North Korea. South Korean government officials reportedly have stated that resolving the ongoing North Korean nuclear crisis is a prerequisite for starting any "new" inter-Korean economic programs, presumably including the expansion of the Kaesong site beyond the pilot program.

## **Major U.S. Trade Disputes with South Korea**

Given the disparities in size and economic dependence, it is not surprising that the United States typically sets the agenda of U.S.-ROK trade talks. Since the 1997 financial crisis, these complaints have tended to be directed at regulations promulgated by "domestic" ministries, such as the Ministry of Health and Welfare and the Ministry of Commerce and Industry, that traditionally have had little contact with foreign governments or firms. One element of the U.S. strategy toward Korea appears to be attempting to raise the pressure on these ministries by pushing for the Korean Cabinet to focus on the issue.

In general, U.S. exporters and trade negotiators identify the lack of transparency of Korea's trading and regulatory systems as the most significant barriers to trade with Korea, in almost every major product sector. In 2004, the transparency issue became a standalone item in the quarterly trade action agenda meetings. Many U.S. government officials also complain that Seoul continues to use government

regulations to discriminate against foreign firms in politically sensitive industries, such as automobiles and consumer electronics. Another major cross-sectoral complaint is that restrictions in the Korean labor market, such as mandatory severance pay, raise the cost of investing and doing business. Finally, the United States and other countries have pressed South Korea to open further its agricultural market, which is among the most closed in the OECD.<sup>9</sup>

Below are brief descriptions of several major sector-specific disputes between the U.S. and South Korea.

**Telecommunications.** In recent years, telecommunications has emerged as one of the most contentious trade issues between the United States and South Korea. South Korea has one of the world's highest rates of Internet usage, and cell-phone use is ubiquitous. The Roh government has designated next-generation mobile communications as one of ten "new growth engines" that will help Korea reach President Roh's goal of nearly doubling per capita GDP to \$20,000 by the end of the decade. Perhaps to this end, the Korean government has attempted to set mandatory, single-technology standards for wireless telecommunications services. These efforts led USTR in April 2004 to name South Korea as a "key country of concern" in its annual report under Section 1377, which requires USTR to assess U.S. trading partners' compliance with international telecommunication agreements.

Specifically, for two years, USTR negotiated with the South Korean government over the Ministry of Information and Communication's (MoIC) plan to require all cell phone services to use only the so-called wireless Internet platform for interoperability (WIPI) for downloading information from the Internet. WIPI is a new platform developed by a Korean association funded by Electronics and Telecommunications Research Institute (ETRI), a government-funded institute. The requirement would have excluded users and developers of other operability platforms, such as the platform developed by San Diego-based Qualcomm, which is used by a leading Korean cellular service provider. In April 2004, Seoul and Washington announced they had reached a compromise that allows MoIC to implement WIPI, but also permits cellular phones to be made compatible with other standards.<sup>10</sup>

A similar dispute is over MoIC's plan to issue a mandatory standard — to be located in the 2.3 gigahertz (GHz) bandwidth spectrum — in 2004 for portable wireless Internet services ("Wi-Fi") used to transmit information from the Internet to laptops and other wireless equipment. USTR and U.S. companies have charged that, under the influence of ETRI, the standard is being developed to deliberately exclude foreign companies in favor of Samsung.<sup>11</sup> In the June quarterly trade meeting, South Korean trade officials reportedly told their U.S. counterparts that

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<sup>9</sup> OECD, *Economic Survey - Korea 2004*.

<sup>10</sup> "U.S., Korea Reach Deal on Single Standard for Cell Phone Technology," *Inside US Trade*, April 30, 2004.

<sup>11</sup> USTR, "Results of 2004 Section 1377 Review of Telecommunications Trade Agreements," p. 5.

Seoul would no longer mandate a Korean standard, but instead would mandate an international draft standard that Samsung participated in creating. Most U.S. companies seeking to enter the Korean market use a rival standard.<sup>12</sup>

**Automotive Trade.** South Korea, the world's fourth-biggest producer of automobiles, has long maintained a variety of barriers to the import of automobiles. The ban on Japanese automobiles was eliminated in 1999. In its October 1997 Super 301 report to Congress, the Clinton Administration designated Korea as a "Priority Foreign Country" for its barriers to foreign motor vehicles.<sup>13</sup> USTR subsequently initiated an investigation under Section 301 of the U.S. Trade Act of 1974, as amended, and issued a call for bilateral consultations to provide fair market access for foreign autos in Korea.<sup>14</sup> In 1998, the U.S. and South Korea signed a Memorandum of Understanding (MOU) on foreign access to Korea's auto market, which led the USTR to terminate the Section 301 investigation. Under the MOU, Seoul agreed to reduce its tariffs on motor vehicles from 80% to 8%,<sup>15</sup> proactively address instances of anti-import activity in Korea, lower or eliminate many automobile taxes, create a new financing system to make it easier to purchase automobiles, and streamline its standards and certification procedures. Many of these steps — including lowering tariffs — have been implemented, and in 2002 General Motors purchased the Daewoo Motor Company from the bankrupt Daewoo conglomerate. The United States, however, continues to protest that South Korean tax and regulatory practices have discriminated against imports of foreign automobiles.

Despite these efforts, imports of foreign automobiles totaled less than 20,000 in 2003 — including 4,460 U.S. cars — less than 2% of the South Korean market. (See Table 3.) In contrast, South Korean auto manufacturers exported over 630,000 cars to the United States in 2003. Nearly all of these vehicles were produced by Hyundai Motors. Automotive trade continues to be a perennial issue in the quarterly trade talks, during which U.S. officials argue that Korean tax and regulatory practices continue to discriminate against imports. USTR is pushing South Korea to lower its 8% tariff and has protested that South Korea's tariff, tax, and regulatory structure

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<sup>12</sup> June 2004 conversation with a participant in the talks.

<sup>13</sup> Super 301 (Section 310 of the 1974 Trade Act) requires the USTR to report to congress on "priority foreign countries" that practice unfair trade and "priority practices" that have the greatest effect on restricting U.S. exports. If agreement is not reached on the priority practices, the USTR is required to initiate a Section 301 case (see the following footnote). For more information, see Wayne Morrison, *Section 301 of the Trade Act of 1974*, CRS Report 98-454.

<sup>14</sup> Section 301 (sections 301-309 of the Trade Act of 1974) authorize the USTR to initiate investigations of foreign trade practices that allegedly discriminate against U.S. commerce. If a settlement with the foreign country is not reached following the initiation of the investigation, the USTR decides whether or not to retaliate, usually in the form of 100% tariffs on selected imports from the offending country. See CRS Report 98-454, *Section 301 of the Trade Act of 1974*, as Amended: Its Operation and Issues Involving its Use by the United States, by Wayne Morrison.

<sup>15</sup> By way of comparison, the U.S. tariff on passenger vehicles is 2.5%. The Japanese tariff rate is 0%.

unfairly penalize automobiles with larger-sized engines. Specifically, the Bush Administration has called on Korea to move from engine displacement taxation to a value-based taxation system, because the former assesses higher taxes on larger vehicles.<sup>16</sup> Periodically, some Members of Congress have introduced legislation calling on South Korea to end the practices that impede foreign market access and requesting various U.S. executive agencies to monitor Korea's progress on this issue. Two initiatives were H.Con.Res. 144 and S.Con.Res. 43, introduced in the 107<sup>th</sup> Congress, in May 2001.

**Table 3. U.S.-ROK Automotive Trade**

Vehicular Units, including Light Trucks; Rounded to Nearest 100 Unit

	1999	2000	2001	2002	2003
Korean Auto Companies' Exports to the U.S.	329,600	473,400	618,300	650,300	637,700
<i>Market Share</i>	2.0%	2.7%	3.6%	3.9%	3.8%
Total Foreign Auto Companies' Exports to Korea	2,400	4,400	7,700	16,100	19,500
<i>Market Share</i>	0.2%	0.3%	0.5%	1.3%	1.9%
U.S. Auto Companies' Exports to Korea	1,400	1,700	2,000	4,700	4,100
<i>Market Share</i>	0.1%	0.1%	0.1%	0.4%	0.4%

Source: U.S. Department of Commerce

In 2002, Hyundai Motors announced it would build a \$1 billion plant in Montgomery, Alabama. The facility, which is scheduled to begin production in March 2005, is expected to produce 300,000 vehicles annually and will employ approximately 2,000 workers.<sup>17</sup>

**South Korea's Alleged Currency Manipulation.** In recent years, South Korea has been criticized for intervening in foreign currency markets by purchasing U.S. dollar assets to artificially lower the value of the Korean *won* against the U.S. dollar in order to boost exports. As Figure 4 shows, the *won* generally has been appreciating against the dollar since 2002. In response, South Korean authorities have intervened episodically to slow the *won*'s rise, though the scale of the intervention has been far less than Japan's and China's. The United States made currency intervention a major issue at the APEC Finance Ministers and G-7 Finance Ministers meetings in September 2003. Shortly thereafter, South Korea appears to have momentarily eased off its interventionist policies. Also in September, congressional criticism of Korea's currency policy increased. S. 1592 (The Fair Currency Enforcement Act of 2003) was introduced, calling on the U.S. government to monitor and take action against specific countries, including South Korea, that are "engaged most egregiously in currency manipulation."

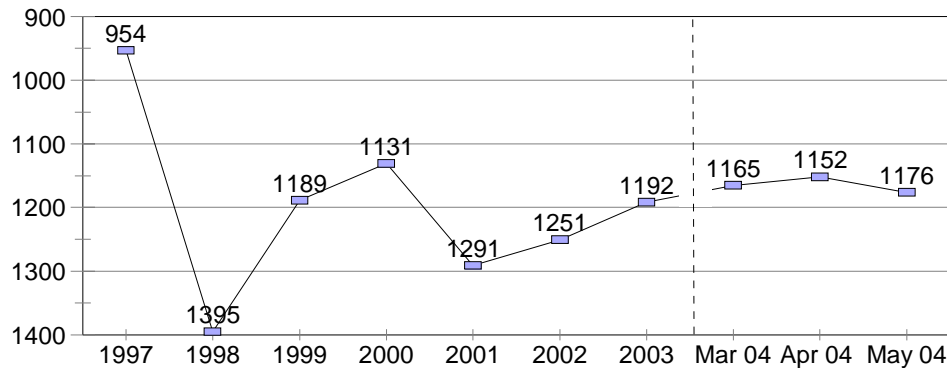
<sup>16</sup> USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers*, p.313.

<sup>17</sup> June 2004 conversation with Hyundai Motors official.



**Figure 4. Won:Dollar Exchange Rate, 1997-2004**

Average Closing Rate, Longer Frequency



Source: Bank of Korea. Note that Y-axis is inverted.

In the future, the U.S. dollar and the market for U.S. treasury securities could be affected by South Korea's plan to give over \$100 billion of its foreign-exchange reserves to private asset-management firms by 2012. The stated goals of the program, which is due to begin in 2005, are to invest South Korean foreign currency holdings more effectively, and to boost President Roh Moo-hyun's efforts to turn Korea into a major financial and commercial hub in Northeast Asia. As of the end of April 2004, South Korea was the tenth largest foreign holder of U.S. treasury securities, holding \$39.3 billion.<sup>18</sup>

**Intellectual Property Rights Issues.** Bilateral tensions often have arisen over U.S. allegations that Korea does not sufficiently protect intellectual property rights (IPRs). Since becoming a signatory to the World Trade Organization (WTO) Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) in 1994, USTR has moved Korea back and forth between the Special 301 "priority watch list" and the "watch list."<sup>19</sup> Most recently, in January 2004, Korea was elevated to the "priority watch list" in part because of Seoul's alleged reluctance to prevent the growth of online music piracy and continued piracy of U.S. motion pictures. The South Korean government has protested this move. Perhaps in response to the U.S. action, in May 2004 then-acting South Korean President Goh Kun launched a "Pan-Government Comprehensive Plan For IPR Protection" to be

<sup>18</sup> Department of the Treasury and the Federal Reserve Board, "Major Foreign Holders of Treasury Securities," [http://www.ustreas.gov/tic/mfh.txt]. Japan held \$646 billion in U.S. treasury securities, the United Kingdom \$163 billion, and China \$152 billion.

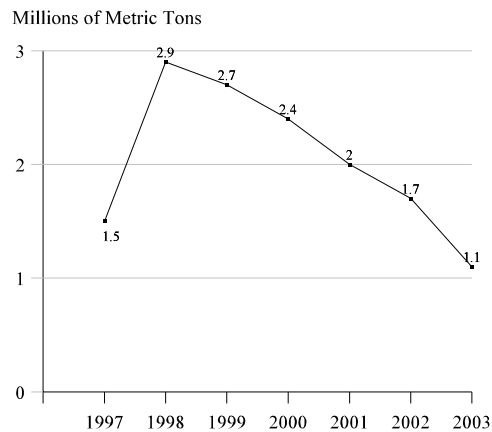
<sup>19</sup> "Special 301" refers to Section 182 of the Trade Act of 1974. Since the start of the Special 301 provision in 1989, the USTR has issued annually a three-tier list of countries judged to have inadequate regimes for IPR protection, or to deny access: 1) *priority foreign countries* are deemed to be the worst violators, and are subject to Section 301 investigations and possible trade sanctions; 2) *priority watch list countries* are considered to have major deficiencies in their IPR regime, but do not currently warrant a Section 301 investigation; and 3) *watch list countries*, which maintain IPR practices that are of particular concern, but do not yet warrant higher level designations. See Wayne Morrison, *Section 301 of the Trade Act of 1974*, CRS Report 98-454.

headed by a Han Duk-soo, a prominent official who will have a seat in the Cabinet to promote the initiative. Both sides report that progress was made in the spring of 2004 on the issue of motion picture piracy.

**Rice.** The United States is trying to increase exports of U.S. rice into South Korea. The South Korean government controls the purchase, distribution, and end-use of all imported rice. During the Uruguay Round of multilateral trade negotiations (1986-1993), South Korea was granted a 10-year grace period before opening its rice market to imports. In return for receiving this concession, South Korea agreed to allow minimum access for rice through the use of quotas. The grace period ends in 2005. South Korea has notified the WTO that it wishes to extend the minimum access quota system rather than convert to tariffs. Under the Uruguay Round agreement, Seoul can do this only if it obtains the consent of other WTO members, which can demand concessions to expand market access. U.S. officials reportedly are prepared to agree to a continuation of the minimum access system in exchange for an expansion of the overall quota, an end to the ban on imported rice being sold directly to Korean consumers, and/or a guarantee that the United States would be given a minimum share of the quota. China and Thailand, two other parties to the rice negotiations, reportedly wish to see an end of the quota system in favor of tariffication, which presumably would be more advantageous to lower-cost rice producers such as themselves. In 2003, U.S. exporters sold 55,000 metric tons (MT) of rice — or about 28% of the 200,000 MT minimum access quota — to South Korea, behind China's exports of 115,000 MT.<sup>20</sup>

**Steel.** From 1998 through 2003, South Korean steel exports to the United States were one of the most politically charged items on the bilateral economic agenda, particularly since the 1997 Asian financial crisis. From 1997 to 1998, Korean shipments of steel to the U.S. nearly doubled, vaulting South Korea into the top five U.S. sources of steel imports. In 2003, imports from South Korea declined below pre-crisis levels, helping to defuse the issue. In the preceding five years, a number of anti-dumping cases were initiated against South Korean exporters, and Presidents Clinton and Bush each granted safeguard relief (under Section 201 of the Trade Act of 1974) for U.S. steel producers.<sup>21</sup> Korea

**Figure 5. Steel Imports from Korea, 1997-2003**



Source: U.S. Census Bureau

<sup>20</sup> Inside US Trade, "Fight over Korean Rice Market Pits China Against U.S., Australia," June 11, 2004.

<sup>21</sup> Section 201 relief, often referred to as "safeguard" or "escape clause" relief, is defined in sections 201-204 of the Trade Act of 1974, as amended (19 U.S.C. 2251-2254). Safeguard relief provides for temporary duties, quotas, or other restrictions on imports that may be traded fairly, but that enter in such quantities as to cause or threaten to cause serious (continued...)

and other countries challenged both Section 201 actions at the World Trade Organization, which ultimately ruled that the actions were inconsistent with global trading rules. In December 2003, partly in response to one of these WTO panel rulings, President Bush terminated the safeguard tariffs he had established in March 2002.<sup>22</sup> In 2000, Korea also won a major WTO case involving anti-dumping duties the U.S. imposed against Korean exports of stainless steel plate in coils and stainless steel sheet and strip.

**Assistance to Hynix Semiconductor.** In 2001, a major trade dispute erupted between the United States and South Korea over allegations that the Seoul government was propping up Hynix Semiconductor, presently the world's third-largest producer of dynamic random access memory (DRAM) semiconductor chips. In 2001 and 2002, Hynix's leading creditors — most of which were owned by the Korean government — orchestrated a series of rescue packages that kept Hynix in business by enabling it to restructure its 8.6 trillion *won* (over \$7 billion) in debt. In the U.S., Micron Technology, the Idaho-based second largest producer of DRAMs, led a campaign against the support packages, arguing that they amounted to government-sponsored bailouts that allow Hynix to export at low prices and that they were a prime cause of the drastic plunge in global chip prices in 2001 and 2002. Micron, the last U.S.-based DRAM producer, eventually filed a countervailing duty case, which it won, resulting in a 44% punitive tariff being assessed against Hynix's exports to the United States. In a similar case, the European Union imposed a 34% counter-vailing duty against Hynix. Korea has challenged both rulings in the WTO. A WTO panel has been formed and is due to issue a ruling later this year. Semiconductors are the second-largest U.S. import from (and largest export to) Korea.

**Pharmaceuticals.** Korea is ranked in the world's top 15 pharmaceutical markets, with annual sales in the \$4 billion range. In 2001, imports comprise approximately 30% of the total market, compared with an average of 50%-70% for countries that do not have a significant research-based domestic industry. Korea's expenditures on pharmaceutical products is about \$115 per person, less than half the \$240 average for OECD countries.<sup>23</sup> The country has a nationalized health insurance system, which has had a negative cash flow since 1995. For years, the U.S. government has raised complaints about a number of Korea's pharmaceutical policies, which it describes as "onerous," non-science based, and designed to protect

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<sup>21</sup> (...continued)

injury to a domestic industry. The relief is intended to give the domestic industry an opportunity to adjust to the new competition and remain competitive. Within six months after a Section 201 petition has been filed with the International Trade Commission, the ITC must conduct an investigation, determine if relief is warranted, and recommend appropriate remedial action from a specified range of options. The President then decides whether to implement the recommended measure, apply an alternative measure, or take no action at all.

<sup>22</sup> For more on the steel Section 201 case, see CRS Report RL32333, *Steel: Price and Availability Issues*, by Stephen Cooney.

<sup>23</sup> American Chamber of Commerce in Korea, *Improving Korea's Business Climate 2002*, p. 148.

the domestic Korean industry.<sup>24</sup> Criticisms have mounted since 2001, when the Korean government began to implement a series of emergency measures to fill the national health insurance fund's mounting deficit, estimated at the time to be over 4 trillion *won* (\$3.3 billion). Recent complaints include the lack of transparency of the Korean Ministry of Health and Welfare, particularly the Ministry's allegedly poor record on consulting with and notifying companies about regulatory changes; poor protection of intellectual property rights for medical patents; and the discriminatory nature of Seoul's requirements that foreign drugs must be retested on Koreans living in Korea, rather than on other ethnic Asians, as the U.S. has insisted. In a sign of pharmaceuticals' growing importance on the bilateral trade agenda, in January 2002, the two sides established a bilateral private sector health care reform working group.

**South Korea's Performance in the Doha Development Agenda.** In the current round of multilateral trade talks, the Doha Development Agenda, although USTR Robert Zoellick has praised South Korea for attempting to bridge the difference between the developed and developing countries, Seoul also has been criticized for resisting agricultural liberalization in the negotiations. Korea's tariffs on agricultural products, except rice, average 66%, compared with a 7.5% average for tariffs on industrial products.<sup>25</sup>

**Korea's Complaints Against U.S. Anti-Dumping and CVD Practices.** For over a decade, South Korea has chafed at the United States' use of anti-dumping and counter-vailing duty (CVD) laws to raise tariffs on Korean exports. According to one study, in July 2000 the five CVD and 18 anti-dumping orders against South Korean exports covered approximately \$2.5 billion, or over 7%, of U.S. imports from South Korea in 1999. Moreover, these tariff hikes have tended to be concentrated in a handful of Korean industries — semiconductors, steel, televisions, and telecommunications equipment — that have considerable political influence in Seoul.

During the Uruguay Round (1986-1993) of the General Agreement on Tariffs and Trade (GATT, the WTO's predecessor organization), Korea was one of several countries demanding revisions to global anti-dumping rules, changes the United States opposed because of fears they would constrain U.S. anti-dumping investigators. South Korea, joined most prominently by Japan, has taken up this issue again in the Doha Development Agenda talks, against U.S. opposition.<sup>26</sup>

In recent years, Seoul has become more assertive in using the WTO to challenge United States' trade practices. In 1999 and 2000, Seoul took the U.S. to the WTO over allegedly discriminatory U.S. anti-dumping duties placed on Korean exports of steel and semiconductors. Korea won both of the steel cases it initiated.

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<sup>24</sup> United States Trade Representative, *2001 National Trade Estimate Report on Foreign Trade Barriers*, p. 288, 294-96.

<sup>25</sup> USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers*, p.290.

<sup>26</sup> Notwithstanding Korea's position on anti-dumping, U.S. trade officials have praised their Korean counterparts for their willingness to compromise and serve as a bridge to developing countries during the November 2001 WTO Ministerial talks in Doha, Qatar.

**U.S. Visa Policies.** South Koreans' complaints about U.S. visa policies tend to fall into two categories.<sup>27</sup> First, some Korean government officials, Korean businesses, the American Chamber of Commerce in Korea, and Korean-Americans have questioned why South Korea is not a participant in the U.S. Visa Waiver Permanent Program, under which foreigners traveling from certain countries are permitted to travel to the U.S. as temporary visitors, without having the immigration documents normally required for entry.<sup>28</sup> Among the statutory requirements for countries to participate in the U.S. visa waiver program is that the country must have a low nonimmigrant visa refusal rate for two years — averaging no more than 2% over both years and not exceeding 2.5% in any one year. According to State Department officials, South Korea's visa refusal rates have consistently been over this threshold. U.S. State Department officials attribute the rise in Korea's refusal rates since 1997 to the increased number of Koreans illegally seeking to find work in the United States.

The second, and more recent, category of complaints are lodged against new U.S. visa policies implemented since the September 2001 terrorist attacks on the United States, particularly requirements for mandatory interviews, fingerprinting, and greater scrutiny of business travelers for possible technology transfer risks. Like citizens of many other countries, Koreans particularly have objected to the fingerprinting, which some Koreans have likened to requirements imposed upon them during Japan's thirty-five-year occupation of the Korean Peninsula in the first half of the 20<sup>th</sup> Century. According to the U.S. embassy in Seoul, U.S. businesses lost hundreds of millions of dollars from Korean students, tourists, and businesspeople who could not or would not travel to the United States because of the new requirements.<sup>29</sup> South Korean government officials reportedly raised the visa issue in the June 2004 quarterly trade talks with the United States.

## **Institutionalizing the U.S.-ROK Economic Relationship?**

**Bilateral Investment Treaty Negotiations.** For several years, the United States and South Korea have been discussing a bilateral investment treaty (BIT). BITs are designed to improve the climate for foreign investors — typically by committing the signatories to prohibit discrimination against foreign investors — by establishing dispute settlement procedures and by protecting foreign investors from performance requirements, restrictions on transferring funds, and arbitrary expropriation. The United States has signed over 30 BITs, primarily with countries undergoing significant economic reforms. The U.S. and South Korea last held formal negotiations in 1999. The major stumbling block is Korea's so-called "screen quotas," which require that theaters fill 40% of their screen time with Korean

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<sup>27</sup> For more on U.S. visa policies, see CRS Report RL31512, *Visa Issuances: Policy, Issues, and Legislation*, by Ruth Wasem.

<sup>28</sup> For more on the visa waiver program, see CRS Report RL32221, *Visa Waiver Program*, by Alison Siskin.

<sup>29</sup> May 19, 2004 conversation with State Department official.

movies. The U.S. side has made a loosening and eventual elimination of the quotas preconditions for signing a BIT, which some in South Korea are eager to complete in order to turn to their next agenda item: a U.S.-South Korea free trade agreement (FTA). In a sign that the BIT talks may be restarted, in mid-June 2004, the South Korean Minister of Culture and Tourism, previously a staunch backer of maintaining the screen quota, reportedly told a gathering of South Korean film industry executives that it was time to consider loosening the quotas.<sup>30</sup>

**A Possible Korea-U.S. Free Trade Agreement (FTA).** In recent years, there have been some calls for the United States and Korea to negotiate a free trade agreement, which would lower trade barriers between the two countries. The idea enjoys the support of the American business community in Korea, and many Korean businesses operating in the United States. In the previous two Congresses, Senator Max Baucus introduced legislation (S. 944 in the 107<sup>th</sup> Congress and S. 1869 in 106<sup>th</sup> Congress) authorizing FTA negotiations with Seoul. No legislative action was taken on either attempt. To date, no formal government-to-government discussions have been held over an FTA. USTR Robert Zoellick has said that the United States would be interested in an FTA, but that before negotiations begin progress must be made in outstanding bilateral trade irritants, particularly in opening South Korea's agricultural market.<sup>31</sup>

In 2001, at the request of the Senate Finance Committee, the International Trade Commission conducted a fact-finding investigation on the likely economic impact of a South Korea-U.S. FTA. The ITC's final report estimated that within four years after implementation of an FTA, U.S. exports to Korea would increase by 54% while U.S. imports would rise by 21%. In the short run, the biggest beneficiaries would likely be those industries in both countries that face high initial trade barriers. On the U.S. side, the ITC found that bilateral agricultural exports would increase by more than 200%. For Korea, the ITC projected that textiles and apparel exporters would see their shipments to the U.S. rise by 125%.<sup>32</sup> Thus, the report implied that the FTA's potential benefits would be greatly diluted if these politically sensitive sectors were excluded.<sup>33</sup>

Overall, the ITC estimated that within four years after implementation of an FTA, U.S. GDP would increase by approximately 0.2%, while Korean GDP would rise by 0.7% as a result of an FTA.<sup>34</sup> An earlier study by the Institute for International Economics (IIE), found similar effects for the U.S. economy, but had a wider band for the increase on Korean GDP, which was projected in the 0.4%-2.0% range. As in the ITC study, the IIE report found that most of the benefits to U.S. firms would derive from increased access to Korea's market. In contrast, the IIE

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<sup>30</sup> "Culture Minister Concedes to Less Movie Protection," *Joins.com*, June 13, 2004.

<sup>31</sup> June 2004 conversation with USTR official.

<sup>32</sup> United States International Trade Commission (ITC), *U.S.-Korea FTA: The Economic Impact of Establishing a Free Trade Agreement (FTA) Between the United States and the Republic of Korea*, (Washington, DC, 2001), p. 5-1 - 5-2.

<sup>33</sup> For a similar argument, see Choi and Schott, *Free Trade*, p.80.

<sup>34</sup> ITC, *U.S.-Korea FTA*, p. x-xi.

projected that most of Korea's gains from an FTA would stem not from preferential access to the U.S. market but from improvements in the allocative efficiency of the Korean economy brought about the trade reforms required by an FTA.<sup>35</sup> In 2004, the Korean National Assembly ratified Korea's first FTA, with Chile, after protracted parliamentary deliberations. Korea also is negotiating FTAs with Japan and Singapore.

## **Recent Legislation in the 108<sup>th</sup> Congress**

### **S. 1592 (Lieberman)**

The Fair Currency Enforcement Act of 2003 calls on the U.S. government to monitor and take action against South Korea, China, Japan, Taiwan, and other countries, that are "engaged most egregiously in currency manipulation." Introduced September 8, 2003; referred to Senate Finance Committee.

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<sup>35</sup> See Choi and Schott, *Free Trade*, p. 79-82.